U S WEST, Inc.
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EX PARTE OR LATE FILED

ORIGINAL

USWEST

James T. Hannon
Senior Attorney

July 23, 1999

EX PARTE

Ms. Magalie Roman Salas, Secretary
Federal Communications Commission
445 12th Street, SW, TW-A325
Washington, D.C. 20554

Re: Petition of U S WEST Communications, Inc. for Forbearance from Regulation as a Dominant Carrier for High Capacity Services in Phoenix, Arizona MSA, CC Docket No. 98-157

Petition of U S WEST Communications, Inc. for Forbearance from Regulation as a Dominant Carrier for High Capacity Services in Seattle, Washington MSA, CC Docket No. 99-1

Dear Ms. Salas:

Attached are copies of letters and documents which were sent to Kyle Dixon, Bill Bailey, Linda Kenney, Dorothy Attwood and Sarah Whitesell as a follow-up to meetings which U S WEST had with the legal advisors on the above-captioned proceedings on July 8 and 9, 1999.

In accordance with Section 1.1206(a)(1) of the Commission's rules, the original and one copy of this letter, with attachment, are being filed with your office. Acknowledgment and date of receipt of this transmittal is requested. A duplicate of this letter is included for this purpose.

Please contact me should you have any questions concerning this matter.

Sincerely,

James T. Hannon (RW)

James T. Hannon

Attachments

Cc: Kyle Dixon
Bill Bailey
Linda Kenney
Dorothy Attwood
Sarah Whitesell
Tamara Preiss
Howard Shelanski

No. of Copies rec'd 0+1
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James T. Hannon
Senior Attorney

USWEST

July 23, 1999

EX PARTE

William Bailey
Federal Communications Commission
445 12th Street, SW, 5-C434
Washington, D.C. 20554

Re: Petition of U S WEST Communications, Inc. for Forbearance from Regulation as a Dominant Carrier for High Capacity Services in Phoenix, Arizona MSA, CC Docket No. 98-157

Petition of U S WEST Communications, Inc. for Forbearance from Regulation as a Dominant Carrier for High Capacity Services in Seattle, Washington MSA, CC Docket No. 99-1

Dear Mr. Bailey:

On July 9, 1999, Melissa Newman, John Kure and I met with you to discuss U S WEST's petitions for forbearance from regulation as a dominant carrier in the provision of high capacity services in the Phoenix and Seattle metropolitan areas. At the time, we indicated we would be responding to the generalized and unsupported arguments that Dr. Daniel Kelley of HAI Consulting made on behalf of the Association of Local Telecommunications Services ("ALTS") in support of his assertion that high capacity markets are not competitive and that forbearance and pricing flexibility are premature.

In preparing the Section 10 forbearance petitions for Phoenix and Seattle, we asked Professors Alfred Kahn and Timothy Taridiff to assess U S WEST's market power in the market for high capacity services in these two cities using the same approach that the Commission previously employed in the AT&T non-dominant proceeding. In both cases, Kahn and Tardiff concluded that U S WEST lacks market power in the provision of high capacity services. After receiving Dr. Kelley's paper, we asked Kahn and Tardiff to review their earlier work in light of Mr. Kelley's assertions. Their response is attached for your consideration.

In the attached paper, Kahn and Tardiff point out that "Dr. Kelley's arguments are striking in their lack of specific information on which to judge the merits of U S WEST's petitions." They criticize Dr. Kelley's proposed prerequisites for pricing flexibility as measures that "are so extreme that they appear to be designed to delay indefinitely the requested—and in our judgement wholly desirable – regulatory flexibility that these carriers request." Kahn and Tardiff summarize their response with the following statement:

> Competition itself, without dominant firm regulation, is sufficient to deny U S WEST the ability to impose anticompetitive prices and other conditions in

> this rapidly expanding, competitively turbulent market. In these circumstances, the costs of continued dominant firm regulation in this market clearly exceed whatever benefits it could possibly confer.

U S WEST concurs in Kahn and Tardiff's conclusions with respect to the market for high capacity services in Phoenix and Seattle.

For your convenience, I have also included copies of Kahn and Tardiff's analysis and rebuttal which were filed in connection with U S WEST's petition for Seattle.

Sincerely,

James T. Hannon

James T. Hannon

Attachments

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James T. Hannon
Senior Attorney

USWEST

July 23, 1999

EX PARTE

Kyle Dixon
Federal Communications Commission
445 12th Street, SW, 8B-204
Washington, D.C. 20554

Re: Petition of U S WEST Communications, Inc. for Forbearance from Regulation as a Dominant Carrier for High Capacity Services in Phoenix, Arizona MSA, CC Docket No. 98-157

Petition of U S WEST Communications, Inc. for Forbearance from Regulation as a Dominant Carrier for High Capacity Services in Seattle, Washington MSA, CC Docket No. 99-1

Dear Mr. Dixon:

On July 9, 1999, Melissa Newman, John Kure and I met with you to discuss U S WEST's petitions for forbearance from regulation as a dominant carrier in the provision of high capacity services in the Phoenix and Seattle metropolitan areas. At the time, we indicated we would be responding to the generalized and unsupported arguments that Dr. Daniel Kelley of HAI Consulting made on behalf of the Association of Local Telecommunications Services ("ALTS") in support of his assertion that high capacity markets are not competitive and that forbearance and pricing flexibility are premature.

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Sincerely,

James T. Hannon

James T. Hannon (RW)

Attachments

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James T. Hannon
Senior Attorney

USWEST

July 23, 1999

EX PARTE

Sarah Whitesell
Federal Communications Commission
445 12th Street, SW, 8C-302
Washington, D.C. 20554

Re: Petition of U S WEST Communications, Inc. for Forbearance from Regulation as a Dominant Carrier for High Capacity Services in Phoenix, Arizona MSA, CC Docket No. 98-157

Petition of U S WEST Communications, Inc. for Forbearance from Regulation as a Dominant Carrier for High Capacity Services in Seattle, Washington MSA, CC Docket No. 99-1

Dear Ms. Whitesell:

On July 9, 1999, Melissa Newman, John Kure and I met with you to discuss U S WEST's petitions for forbearance from regulation as a dominant carrier in the provision of high capacity services in the Phoenix and Seattle metropolitan areas. At the time, we indicated we would be responding to the generalized and unsupported arguments that Dr. Daniel Kelley of HAI Consulting made on behalf of the Association of Local Telecommunications Services ("ALTS") in support of his assertion that high capacity markets are not competitive and that forbearance and pricing flexibility are premature.

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For your convenience, I have also included copies of Kahn and Tardiff's analysis and rebuttal which were filed in connection with U S WEST's petition for Seattle.

Sincerely,

James T. Hannon (kw)

James T. Hannon

Attachments

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James T. Hannon
Senior Attorney

USWEST

July 23, 1999

EX PARTE

Linda Kinney
Federal Communications Commission
445 12th Street, SW, 8B-115
Washington, D.C. 20554

Re: Petition of U S WEST Communications, Inc. for Forbearance from Regulation as a Dominant Carrier for High Capacity Services in Phoenix, Arizona MSA, CC Docket No. 98-157

Petition of U S WEST Communications, Inc. for Forbearance from Regulation as a Dominant Carrier for High Capacity Services in Seattle, Washington MSA, CC Docket No. 99-1

Dear Ms. Kinney:

On July 9, 1999, Melissa Newman, John Kure and I met with you to discuss U S WEST's petitions for forbearance from regulation as a dominant carrier in the provision of high capacity services in the Phoenix and Seattle metropolitan areas. At the time, we indicated we would be responding to the generalized and unsupported arguments that Dr. Daniel Kelley of HAI Consulting made on behalf of the Association of Local Telecommunications Services ("ALTS") in support of his assertion that high capacity markets are not competitive and that forbearance and pricing flexibility are premature.

In preparing the Section 10 forbearance petitions for Phoenix and Seattle, we asked Professors Alfred Kahn and Timothy Taridiff to assess U S WEST's market power in the market for high capacity services in these two cities using the same approach that the Commission previously employed in the AT&T non-dominant proceeding. In both cases, Kahn and Tardiff concluded that U S WEST lacks market power in the provision of high capacity services. After receiving Dr. Kelley's paper, we asked Kahn and Tardiff to review their earlier work in light of Mr. Kelley's assertions. Their response is attached for your consideration.

In the attached paper, Kahn and Tardiff point out that "Dr. Kelley's arguments are striking in their lack of specific information on which to judge the merits of U S WEST's petitions." They criticize Dr. Kelley's proposed prerequisites for pricing flexibility as measures that "are so extreme that they appear to be designed to delay indefinitely the requested—and in our judgement wholly desirable – regulatory flexibility that these carriers request." Kahn and Tardiff summarize their response with the following statement:

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U S WEST concurs in Kahn and Tardiff's conclusions with respect to the market for high capacity services in Phoenix and Seattle.

For your convenience, I have also included copies of Kahn and Tardiff's analysis and rebuttal which were filed in connection with U S WEST's petition for Seattle.

Sincerely,

James T. Hannon

James T. Hannon (RW)

Attachments

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James T. Hannon
Senior Attorney

USWEST

July 23, 1999

EX PARTE

Dorothy Attwood
Federal Communications Commission
445 12th Street, SW, 8B-201
Washington, D.C. 20554

Re: Petition of U S WEST Communications, Inc. for Forbearance from Regulation as a Dominant Carrier for High Capacity Services in Phoenix, Arizona MSA, CC Docket No. 98-157

Petition of U S WEST Communications, Inc. for Forbearance from Regulation as a Dominant Carrier for High Capacity Services in Seattle, Washington MSA, CC Docket No. 99-1

Dear Ms. Attwood:

On July 9, 1999, Melissa Newman, John Kure and I met with you to discuss U S WEST's petitions for forbearance from regulation as a dominant carrier in the provision of high capacity services in the Phoenix and Seattle metropolitan areas. At the time, we indicated we would be responding to the generalized and unsupported arguments that Dr. Daniel Kelley of HAI Consulting made on behalf of the Association of Local Telecommunications Services ("ALTS") in support of his assertion that high capacity markets are not competitive and that forbearance and pricing flexibility are premature.

In preparing the Section 10 forbearance petitions for Phoenix and Seattle, we asked Professors Alfred Kahn and Timothy Taridiff to assess U S WEST's market power in the market for high capacity services in these two cities using the same approach that the Commission previously employed in the AT&T non-dominant proceeding. In both cases, Kahn and Tardiff concluded that U S WEST lacks market power in the provision of high capacity services. After receiving Dr. Kelley's paper, we asked Kahn and Tardiff to review their earlier work in light of Mr. Kelley's assertions. Their response is attached for your consideration.

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For your convenience, I have also included copies of Kahn and Tardiff's analysis and rebuttal which were filed in connection with U S WEST's petition for Seattle.

Sincerely,

James T. Hannon

James T. Hannon (KW)

Attachments

RELAXED REGULATION OF HIGH CAPACITY SERVICES IN PHOENIX AND SEATTLE: THE TIME IS NOW

Alfred E. Kahn and Timothy J. Tardiff

July 23, 1999

RELAXED REGULATION OF HIGH CAPACITY SERVICES IN PHOENIX AND SEATTLE: THE TIME IS NOW

Alfred E. Kahn and Timothy J. Tardiff

July 23, 1999

The purpose of this paper is to respond to the paper submitted by Daniel Kelley[1] on behalf of the Association of Local Telecommunications Services (ALTS). Although Dr. Kelley predictably argues against additional regulatory flexibility for special access services offered by RBOCs, it is significant that he does not respond except in very general terms to any actual petition of an RBOC requesting regulatory forbearance. His paper therefore contains no response to the specific facts proffered by the RBOCs and their experts, or the deductions from those facts set forth in their several petitions. Specifically, he has no direct answer to the data we and U S WEST presented about the level and expansion in market shares of CLECs in the cities covered by the U S WEST petitions, the rapidity of their entry into the high capacity markets in those cities and the high degree of responsiveness of customers to those competitive offerings, all cited in our previous filings. Instead, he relies on (1) vague general criticisms by other parties of the data offered by RBOCs, (2) complaints of other parties to regulators on the extent to which RBOCs have assertedly failed to comply with the Telecommunications Act, and (3) pure speculations about the possibility that RBOCs would engage in anticompetitive conduct if they were granted increased flexibility to compete in high capacity markets. In short, Dr. Kelley's arguments are striking in their lack of specific information on which to judge the merits of U S WEST's petitions. Further, his recommended "measures" that would have to be satisfied as a prerequisite for additional flexibility are arbitrary and unsupported by any economic analysis. These "measures" are so extreme that they appear to be designed to delay indefinitely the requested—and in our judgment wholly desirable—regulatory flexibility that these carriers request.

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[1] Daniel Kelley, "Deregulation of Special Access Services: Timing is Everything," HAI Consulting, June 25, 1999.

I. U S WEST LACKS MARKET POWER OVER HIGH CAPACITY SERVICES

In our previous filings on behalf of U S WEST, we analyzed the high capacity markets in Phoenix and Seattle in terms of the criteria that the FCC itself employs when it considers relaxing dominant firm regulation. We found that application of each of these indexes of competition to the markets under consideration clearly justifies relaxed regulation.

Specifically, the FCC's framework calls for examination of the following indicia of competition: (1) current market share, (2) demand elasticity, (3) supply elasticity, and (4) the relative cost structures of incumbents and entrants, all of which we assessed.

In contrast, Dr. Kelley contents himself merely with enumerating some of the steps a CLEC has to take in entering an area—e.g., acquiring rights-of-way, building facilities, attracting customers, and the like, in support of his simple assertion that entry barriers are high (pp. 14-15). We do not dispute that building and maintaining a successful telecommunications business requires such efforts. What we—and even more important, the objective evidence—dispute is the implication he would draw that these requirements constitute an effective barrier to entry: On the contrary, as we thoroughly documented, that implication is flatly contradicted by the rapid actual entry of CLECs, both in U S WEST territories and nationwide. Both established firms such as AT&T and MCI/WorldCom and newer competitors have entered and continue to enter the local exchange business with growing vigor and strong financial commitment.

Since Dr. Kelley essentially ignores this evidence, it seems desirable for us to summarize it, briefly: Both AT&T and MCI/WorldCom have made major moves into the local exchange business, primarily by acquisition of the largest operating CLECs (TCG and MFS, respectively) and potential local competitors (of which AT&T's acquisitions and alliances with the largest cable television firms are the most dramatic examples). Independent CLECs are also growing in number and scope. By the first quarter of 1998, an industry analyst reported that as a group they were providing more new business lines (almost 500,000) than the

RBOCs[2]—an increase from only 75,000 lines just five quarters earlier. Further, while the two largest CLECs (TCG and MFS) supplied two-thirds of the initial volume of lines, they supplied only one-third of the later volume: the CLECs are not only growing rapidly, their own ranks are becoming less concentrated.

Not surprisingly, the CLECs have been able to attract a tremendous amount of capital to finance this expansion. The Council of Economic Advisors reports that since the passage of the Telecommunications Act, in 1996, CLECs have attracted $30 billion dollars in capital.[3] Some of the instances have been almost breathtaking in their dimensions and rapidity: for example, three firms specializing in xDSL services—Covad, Northpoint, and Rhythms—did not even appear on the list of the CLECs Salomon Smith Barney followed in 1998. As of July 16, 1999, they were worth a total of $14.5 billion—about half of U S WEST's total market value.

Because CLECs have focused to date on the larger business customers that tend to use the high capacity facilities that alone are the subject of the U S WEST petition, local exchange competition is even stronger in this particular market than the foregoing aggregate data suggest. That record leads to the clear conclusion that the ILECs have no insurmountable cost advantage in that market and barriers to entry are not a problem. In terms of the specific indicia employed by the FCC that we applied to assess the state of competition in the two metropolitan areas served by U S WEST that are the subject of its petitions, we cited the relevant evidence that:[4]

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[2] Salomon Smith Barney, "CLECs Surpass Bells in Net Business Line Additions for the First Time," May 6, 1998. The article reports that CLECs added 498,000 new lines, compared with 461,000 for the Bells:

> To put this in perspective, the non-AT&T long distance competitors did not have more incremental minutes than AT&T until 1986, a full 10 years after MCI carried its first switched long distance minute. What this shows is that the combination of access to low cost capital coupled with a clear regulatory and public policy initiative toward opening up local markets has allowed the CLECs as a group to achieve in less than 2 years after the Telecom Act, what it took MCI and other alternative long distance carriers over 10 years to achieve during the 1970s and 1980s. If one takes the obvious logical extension of this, this means that the 50% loss of market share that AT&T saw from 1986 through 1996 could be replicated in the local market in a much quicker time period.

[3] Council of Economic Advisors, "Progress Report: Growth and Competition in U.S. Telecommunications 1993-1998," February 8, 1999.

[4] Alfred E. Kahn and Timothy J. Tardiff, "Economic Evaluation of High Capacity Competition in Phoenix," prepared for filing with the Federal Communications Commission on behalf of U S WEST Communications, Petition of U S WEST Communications for Forbearance from Regulation as a Dominant Carrier in the Phoenix, Arizona MSA, August 14, 1998 and "Economic Evaluation of High Capacity Competition in Seattle," prepared

- U S WEST's *facilities* accounted for under 70 percent of the total sales of high-capacity services in 1998 and that share is rapidly declining;[5] its share of the retail market was under 30 percent.

- CLECs' *facilities* are capturing at least half of the *growth* in demand for high capacity services, which reflects and presages a rapid decline in U S WEST's under-70 percent share of that wholesale business.

- Because high capacity services are used by large, sophisticated users, demand elasticities are high; they drive hard bargains for good prices and are known to shop around for good deals.[6]

- CLECs can expand their current facilities economically and relatively quickly (e.g., within two years) to serve a substantial fraction of U S WEST's current volume. For example, in Seattle, U S WEST's competitors can expand their facilities to serve locations within 1,000 feet of their current networks (which account for 60 percent of the incumbent's high capacity locations)[7] for $46 million, a figure that compares favorably with the revenue potential from this expansion.

Because competition in the metropolitan areas we have examined has reached levels that satisfy the FCC's indicia, we recommended relaxed regulation in those areas. The intention of the Telecommunications Act is both clear and clearly correct: when sufficient competition is present, the continuation of regulation is costly, because of both the cost of the regulatory process itself and the cost to consumers when regulation asymmetrically reduces

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for filing with the Federal Communications Commission on behalf of U S WEST Communications, Petition of U S WEST Communications for Forbearance from Regulation as a Dominant Carrier in the Seattle, Washington MSA, December 22, 1998.

5 U S WEST *ex parte* presentation, Letter from B B Nugent to Magalie Roman Salas, CC Docket No. 98-157, February 3, 1999.

6 Dr. Kelley (p. 11) discounts the importance of retail customer contact by providing an estimate of the CLECs' share of the overall local exchange market. Such a share underestimates the CLECs' inroads into business markets, in general, and high capacity markets, in particular, where CLECs have actually garnered over 70 percent of retail business. As we pointed out in our earlier filings, AT&T and MCI have both stated their intention to serve such customers on an end-to-end basis with their own facilities.

7 Demand is even more concentrated. U S WEST has reported that over one-half of its current high capacity volumes are with *100* feet of CLEC facilities.

incentives of particular competitors to establish competitive prices and/or offer innovative products.

Without offering any contradicting facts, Dr. Kelley offers two conceptual criticisms of the market share information offered by U S WEST and other RBOCs. First, he suggests (p. 10) that the high capacity market be subdivided by the individual rate elements of special access services. Because, as U S WEST informs us, high capacity circuits are sold predominantly on an end-to-end basis, and not separately by the rate elements defined in the tariff, this suggestion lacks merit: in assessing the presence or absence of sufficient competition, the market must be defined in terms of the services that are actually bought and sold; in the present instance, the market is clearly one of end-to-end circuits.

Second, Dr. Kelley appears to argue for basing market shares on revenue, rather than physical units.[8] In contrast to his bare assertion that his preferred measure is proper, we discussed this issue in our earlier filings and repeat our reasoning. The objective in calculating the market shares of challengers of a dominant or once-dominant incumbent is to assess their competitive significance. An initial question is whether that is more accurately reflected in their relative dollar sales or physical volumes.

The *Horizontal Merger Guidelines* sets forth the respective bases for using the one or the other:

> Market shares will be calculated using the best indicator of firms' future competitive significance. Dollar sales or shipments generally will be used if firms are distinguished primarily by differentiation of their products. Unit sales generally will be used if firms are distinguished primarily on the basis of their relative advantages in serving different buyers or groups of buyers. Physical capacity or reserves generally will be used if it is these measures that most effectively distinguish firms.[9]

[8] Dr. Kelley's footnote 17 constitutes a cryptic attempt to criticize the market share data presented by U S WEST and the other RBOCs. His main point seems to be that market share should be based on revenue, rather than volumes sold or capacity. In our previous filings we pointed out that (1) the economic literature actually supports basing market share calculations on physical units and (2) because AT&T and MCI/WorldCom now own the two largest CLECs (MFS and TCG), the share of their special access expenditures that goes to CLECs must understate the competitive significance of these alternative sources of supply. We also set forth a rationale for taking into account the capacity of the ILECs' rivals, a rationale that he does not attempt to refute.

[9] *Horizontal Merger Guidelines*, Section 1.41.

Since, in the present instance, the entrants tend to emphasize low price as an entry strategy, it might appear that this reflects, in effect, the "differentiation of their products" that the *Merger Guidelines* envision as calling for use of dollar sales. Against this inference, there are several countervailing considerations.

First, the sales in question are, typically, of services that are not differentiated in any meaningful sense. Modern telecommunications networks are distinguished most fundamentally by their physical ability to transmit information; and that, ultimately, is what will be of primary value to large, well-informed buyers.

Second, as these entrants become—and have become—established, the low prices that they use to break into the market will become of decreasing importance.

Finally, Landes and Posner make a reasonable argument that in calculating the market share of an assertedly dominant firm, the denominator should be composed of its output plus the total physical capacity of its challengers, not their actual output:

> …the sum of the capacity, or potential output, of competitors and the current output of the firm in question should be the denominator in computing the firm's market share. The greater the difference between capacity and current output, the greater is the supply elasticity of competing firms, and therefore the greater is the constraint that these firms place on a firm that tries to raise price above marginal cost.[10]

The implication of these several considerations, we suggest, is that, if anything, the use of market shares defined in terms of current sales in physical units, without taking into account also the *capacity of the competing providers* of high-capacity service in Phoenix and Seattle, understated their competitive significance.

Of course, these competitive indices are just a means to the end of answering the fundamental question: is U S WEST able to charge prices above the competitive level for high capacity services. And on this score, the only specific data Dr. Kelley cites, namely his estimates of the prices and costs of high capacity service (p. 17)—actually support our conclusion. He reports a price of $311 and a cost of $224 for U S WEST's high capacity

[10] William M. Landes and Richard A. Posner, "Market Power in Antitrust Cases," *Harvard Law Review*, Vol. 94, 1981, p. 949.

facilities. From these figures, we calculate a Lerner index of 0.28.[11] This value is quite similar to the Lerner index of 0.29 that Kahai, et al. calculated for AT&T in the long distance market,[12] on the basis of which—in comparison with Lerner indices reported in two other studies—those authors concluded that AT&T has very little market power:

> Comparing Hall's estimate[13] to our estimates for AT&T, we find that, relative to these other industries, AT&T possesses remarkably little market power...The mean value for which Hall's estimates fall within the theoretically acceptable range...is .62. Moreover, the maximum estimate of λ [Lerner index] we obtain for AT&T is .29. This value is below every single industry in Hall's sample...with the single exception of Instruments and Related products. Thus relative to these other industries (virtually all of which are unregulated) AT&T appears to face very effective competition....Bresnahan's survey of prior empirical studies of market power in individual industries presents a table summarizing the Lerner indices estimated by various authors[14]... Almost a dozen industries are represented...The mean Lerner index reported in Besnahan is .296, which is slightly above even our maximum estimate for AT&T. Thus, this second comparison also supports the conclusion that, relative to other firms in the U.S. economy, AT&T possesses very little market power.

In summary, rather than contradicting the findings presented in our previous filings in this investigation, the specific information presented by Dr. Kelley reinforces our fundamental conclusion that the state of competition for high capacity services compares favorably with the state of competition in long-distance at the time at which the FCC granted AT&T non-dominant status.

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[11] The Lerner index is the ratio of the difference between price and cost (311 – 224 = 87) to the price (311). Thus, when the price is close to cost, the Lerner index is close to zero. Note that the index calculated from Dr. Kelley's values is almost surely understated, because the HAI models he employs tend to give low cost estimates. This is so entirely apart from its omission of historical embedded cost: the Lerner index is supposed to be based on the incremental cost *of the seller*: since TELRIC, instead, is designedly intended to measure the costs of a hypothetical most efficient seller, the use of the HAI model would indeed give an exaggerated measure of the Lerner index.

[12] S.M. Kahai, D.L. Kaserman, and J.W. Mayo, "Is the 'Dominant Firm Dominant? An Empirical Analysis of AT&T's Market Power," *The Journal of Law and Economics*, Vol. 39, 1996, pp. 499-517.

[13] R.E. Hall, "The Relation between Price and Marginal Cost in U.S. Industry," *Journal of Political Economy*, Vol. 96, 1988, pp. 921-947.

[14] T.F. Bresnahan, "Empirical Studies of Industries with Market Power," Chapter 17 in R. Schmalensee and R.D. Willig, eds., *Handbook of Industrial Organization*, Vol. 2, Amsterdam: North Holland, 1989.

Despite the similarities in the competitive conditions between the high capacity and the long-distance markets prior to AT&T's receiving non-dominant status, Dr. Kelley would impose much more stringent restrictions on the former. In particular, he would withhold the ability to employ customer contracts, an opportunity the FCC granted AT&T in 1989—*over five years* before it allowed non-dominant regulation, even perhaps to the point of insisting that price reductions made in response to competition should have to be made available to all customers (p. 2). Such uniform pricing is clearly not practiced in long-distance, as prices vary widely across different types of customers—a fact that the FCC recognized when granting nondominant status to AT&T.[15]

In support of his recommendation that ILECs not be permitted to offer contracts, Dr. Kelley argues that they already have sufficient flexibility under current regulation and have not exercised it. In fact, the terms of the price cap regulation to which most of them are subject poses a substantial impediment to downward pricing flexibility, since, to the extent U S WEST takes advantage of it to reduce its prices to any individual customers, in response to competition, those rules require it to reduce its prices equally to all customers in the region. Such a loss of revenue in the non-targeted areas is a cost competitors do not face when they reduce prices. Indeed, the positive purpose of according U S WEST non-dominant treatment would be to eliminate that competitive handicap and thereby enhance its ability to reduce prices: for a seller sufficiently constrained by competition, this increased freedom would be pro- not anti-competitive.

Moreover, there are additional competitive benefits from nondominant status that go well beyond pricing flexibility. In a market in which its competitors are offering sophisticated

[15] In fact, the article by Hausman, et al. that Dr. Kelley cites in footnote 4 reports that AT&T engages in price discrimination in its long-distance services. In a similar vein, Dr. Kelley's speculations about bad outcomes that might result from increased pricing flexibility are not supported by the long-distance experience. For example, on page 23 he claims that increased contracting authority could allow IXCs with greater buying power to command better prices, thus resulting in a more concentrated industry. In fact, price differentiation for access services has been increasing (e.g., through the lower prices for high-volume users that Dr. Kelley describes and through the access charge restructure, beginning in 1994, which among other things abandoned the "equal charge" rule). Yet, competition for special access services have thrived (as we described in our previous filings) and the long-distance industry continues to become less concentrated. For example, since 1993 (when the equal charge rule was abandoned), AT&T's market share has fallen by about 14 percentage points and that of the "big 3" by about 12 percent.

new packages, as both AT&T and MCI/WorldCom announced their intention to do at the completion of their recent mergers, failure to grant U S WEST similar flexibility in the form of the ability to offer products and change prices with minimal notice would dampen both its incentives and its ability to innovate equivalently.

II. U S WEST Has Neither The Incentive Nor The Ability To Engage In Predatory Pricing Or Other Anticompetitive Behavior

Evidently simply on the basis of the identification by some economists of situations in which predatory pricing is possible, Dr. Kelley predicts that there is a substantial danger of it occurring in the markets in question here, without making the slightest effort to ascertain whether the situations are similar. The theoretical support for his argument is his citation (in footnote 31) of a particular, limit-pricing model developed by Milgrom and Robert cited and described in the Tirole textbook. What he neglected to point out is Tirole's explicit warning that the results produced by that model depend heavily on the factual context of the industry under examination:

> The Milgrom-Roberts model shows that limit pricing does occur, but that it is not necessarily harmful. It turns out that the conclusions are sensitive to the data of the problem. This means that the industrial economist must have an intimate knowledge of the industry in question before drawing definitive conclusions about limit pricing.[16]

In fact, the specific industry facts about the Phoenix and Seattle markets for high capacity telecommunications services make predation there extremely unlikely if not flatly inconceivable. The crucial question is whether such prices could drive competitors out of the

[16] J. Tirole, *The Theory of Industrial Organization*, Cambridge: MIT Press, 1988, p. 372. In fact, Tirole's examples to which Dr. Kelley alludes (without identifying the industry) do not support the argument that predation is likely in high capacity markets. Of the three examples, two are consumer products (cigarettes and coffee) that bear very little resemblance to telecommunications services. The third example (natural gas) was identified as a case in which predation was unprofitable. Similarly, the turn-of-the century example in the Levin and Weiman article is much less compelling than Dr. Kelley would have us believe. First, both technology and competitive conditions (CLECs have entered high capacity markets and they are thriving) are different today. Second, a review of the Levin-Weiman article discloses that (1) the authors themselves acknowledge the evidence is equally consistent with a competitive explanation and (2) in the reviewer's view such an explanation was equally plausible. (J.M. Lott, *Are Predatory Commitments Credible?* Chicago: The University of Chicago Press, 1999, p. 6.)

market and keep them out long enough for U S WEST to be able to recoup its losses by higher prices after their departure. The answer is that such a result is extremely difficult if not impossible to envision. The facilities-based competitors already have a great deal of capacity installed: firms do not exit from markets unless prices fall and are held below the variable costs of using those facilities; and the very wide gap between total costs and marginal costs of capacity already in place suggests that any attempt at predation would in any event be extremely costly; the predator would have to push prices far below its own total costs and suffer large losses before it would have any hope of driving its rivals from the market.

Moreover, even if U S WEST's price reductions drove out such particularly unlikely targets for successful predation as AT&T, they would not drive out the *facilities* already installed: the only circumstances under which it would not be profitable for anyone to continue to use those facilities would be if either that continued use were inefficient, because the marginal cost associated with it was higher than the marginal costs incurred by the incumbent, or if the incumbent persisted in pricing its competitive services below its own marginal costs—but for what purpose? Any attempt on its part to recoup those losses by raising rates above competitive levels would not have to be combated by the construction of new facilities. At that point, because the competing facilities would already be in place, some firm—whether the previous rivals or some successor—would find it economic to resume operating them. In a notice of proposed rulemaking, the FCC employed almost identical logic in defending its proposal to give ILEC's increasing freedom to offer contractual rates:

> We do not believe that our contract carriage proposal will lead to predatory pricing as such contracts must be made generally available and are typically long term. Further, ... predatory pricing is likely to occur only if a carrier can eliminate competition and continue to deter potential competitors from entering the marketplace. Once competitors have invested substantial sunk costs necessary to participate in the access market, the existence of those facilities will deter the incumbent from raising rates in the future.[17]

[17] Federal Communications Commission, In the Matter of Price Cap Performance Review for Local Exchange Carriers, CC Docket No. 94-1, Treatment of Operators Services Under Price Cap Regulation, CC Docket No. 93-124, Revisions to Price Cap Rules for AT&T, CC Docket No. 93-197, *Second Further Notice of Proposed Rulemaking in CC Docket No. 94-1, Further Notice of Proposed Rulemaking in CC Docket No. 93-124, and Second Further Notice of Proposed Rulemaking in CC Docket No. 93-197*, September 20, 1995, p. 68

In further proffered demonstration of the possibility or likelihood of predation, Dr. Kelley alludes also to the recent Justice Department complaint against American Airlines.[18] Although we have not studied the merits of that complaint, one of us has for years expressed concern about the possible incidence of predatory behavior in the airline industry.[19] The important point he has consistently made of relevance here is not the likelihood of such behavior in airlines, but the *difference* between airlines and telecommunications that make such behavior unlikely in the latter. We have therefore explicitly considered the question of whether, if accorded non-dominant status, U S WEST could successfully engage in the same sort of tactic in response to entry by firms such as AT&T and MCI/WorldCom. Our consideration is sufficient to conclude emphatically that it would be simply impossible. It should suffice to demonstrate the fundamental difference between the two situations to point out, first, the vast difference between the resources of incumbent airlines and their upstart challengers, in contrast with the far closer to parity of U S WEST and its major local challengers. Second, in a sense even more fundamental, while the incumbent airlines have the ability greatly to increase their capacity on challenged routes, *temporarily*—incurring virtually no sunk or irretrievable costs in the process—and by so doing to force the entrants to pull their equipment out, (1) for incumbent telephone companies to expand fiber optic facilities is extremely costly and (2) the fiber optic facilities of the new entrants in the provision of high capacity service, once installed, are sunk, with marginal costs only a small fraction of their total costs.

Dr. Kelley raises the specter of other kinds of anticompetitive behavior that are equally implausible. For example, he conjectures that an ILEC might raise prices or degrade the

[18] Of course, the mere fact that a business has been sued does not establish the alleged anticompetitive conduct. In fact, *The New York Times* (July 14, 1999) reports that a private suit it characterizes as similar to the Justice Department's claim has been dismissed by a U.S. District Court. In an attempt to establish that current RBOC behavior has been uncooperative, Dr. Kelley employs an even looser standard by merely citing the regulatory complaints of ALTS (footnote 21). The bulk of the ALTS petition deals with its members' demands for unbundled access to network components that provide advanced services—components that the FCC has not yet deemed to be subject to unbundling and which in our opinion fail to satisfy the "necessary" and "impair" standards under the Telecommunications Act. In fact, *The Wall Street Journal* (July 14, 1999) quotes Chairman Kennard as saying: "The key to serving American families is not through more regulations on the cable industry—or more regulation on anyone—but to make sure that there is real, vigorous competition." Clearly, self-serving petitions by some parties for increases in regulation of new services does not establish anticompetitive behavior.

quality of the service it provides to customers not covered by contracts. But of course these speculations merely assume away what U S WEST has, in our judgment, successfully demonstrated—namely, that in the areas in which alone it asks for non-dominant status, it lacks the power to exploit customers in these ways, because CLECs are either already actively competing for their patronage or are capable of extending their networks to serve the bulk of them relatively quickly. In short, the kind of "captive customer" that Dr. Kelley is worried about is rare to non-existent in those markets. Moreover, as we have pointed out in our previous filings, the customers for the high capacity services that alone are the subject of U S WEST's petitions are sophisticated and entirely capable of detecting and not only complaining about any deteriorations in the quality of service U S WEST offers them but fully capable also then of turning to competitive providers.

III. ADDITIONAL PRECONDITIONS TO RELAXED REGULATION ARE UNNECESSARY

Dr. Kelley suggests specific quantitative indices as preconditions of relaxed regulation. Not only is he rather vague about these trial balloons ("Examples of such triggers might be"), he offers no specific economic justification for any of them. In fact, they are totally arbitrary and could well have the effect of delaying indefinitely regulatory flexibility and the intensified competition that it would make possible.

First, he in effect ignores U S WEST's proffered market share data as indicia of the presence or absence of market dominance. Setting aside the consideration that this position of his conveniently ignores the precedent of the FCC's use of just such data in finding AT&T non-dominant, it is true that economists generally would not regard market shares in, let us say, the 35 to 85 percent range as definitive. In this respect, the consensus view would, however, not differ substantially from the one Judge Hand proclaimed in his historic Alcoa decision over fifty years ago:

[19] Kahn, "Comments on Exclusionary Airline Pricing," Submission to the Department of Transportation, September 25, 1998.

> ...ninety percent of supply is enough to constitute a monopoly; it is doubtful whether sixty or sixty-four percent would be enough; and certainly thirty-three percent is not.[20]

How would this general view relate to U S WEST's respective shares of under 70 percent and under 30 percent of the wholesale and retail high capacity markets, respectively? We submit the consensus view would

- regard the retail share as clearly inconsistent with monopoly power and any need for regulation at that level;
- place heavy emphasis on the very rapid decline in both ratios—and, in particular, with respect to the under 70 percent figure, the very rapid continuing expansion of facilities-based competition in just a very few years.
- emphasize heavily—as Dr. Kelley himself recommends "deregulation should be tied to"—"the ability of competitors to reach efficiently and economically a substantial majority of customer locations with owned or leased facilities" (p. 34), a condition that, as U S WEST has demonstrated, is satisfied in the Phoenix and Seattle MSAs.

Additional hurdles are unnecessary and would only delay the benefits of the more vigorous competition that relaxed regulation would bring.

In these circumstances, Dr. Kelley's suggested additional conditions are clearly arbitrary and anti-competitive in their intent. His condition that 20 percent of the loops provided by ILECs be provisioned as UNEs or resold lines is an artificial attempt to dictate the structure of competition. In the case of high capacity services, it is entirely possible that U S WEST could fail to surmount this hurdle even though it currently has no market power, simply because its competitors do not *need* to rely on its facilities to compete for high-volume customers: the evidence shows that they are very rapidly constructing their own. Similarly, Dr. Kelley offers no rationale whatever for his proposed requirement that collocation be available in 90 percent of the wire centers in the LATA. In fact, the distribution of wire centers is highly skewed, with a relatively small number of large offices accounting for a

[20] *United States v. Aluminum Co. of America* 148 F.2d 416, 424 (2d Cir. 1945).